*2011-2012 General Assembly*

# SENATE BILL 826: Revenue Laws Tech., Clarifying, & Admin Chngs

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| **Committee:** | Senate Finance | **Date:** | May 30, 2012 |
| **Introduced by:** | Sens. Rucho, Hartsell | **Prepared by:** | Trina Griffin<br>Committee Counsel |
| **Analysis of:** | PCS to First Edition<br>S826-CSSVx-45 | | |

***SUMMARY: Senate Bill 826, which is a recommendation of the Revenue Laws Study Committee, makes a number of technical, administrative, and clarifying changes to the revenue laws and related statutes, many of which were requested by the Department of Revenue. The technical changes appear in Part I, the clarifying and administrative changes appear in Part II, and changes related to the combined motor vehicle registration and property tax collection system appear in Part III.***

***The PCS makes additional changes, which are shaded in gray, that were requested by the Department of Revenue after the last Revenue Laws Study Committee meeting.***

**[As introduced, this bill was identical to H1026, as introduced by Reps. Howard, Starnes, which is currently in House Finance.]**

**EFFECTIVE DATE:** Except as otherwise provided, this bill would become effective when it becomes law.

**CURRENT LAW & BILL ANALYSIS:**

| Section | Explanation |
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| **PART I: TECHNICAL CHANGES** | |
| 1.1 | A taxpayer is allowed a deduction for the amount by which the basis of a depreciable asset is required to be reduced under the Code for federal tax purposes because of a *tax credit* allowed against the corporation's federal taxable income.<br><br>Section 1603 of ARRTA directs the Treasury to provide cash payments, or grants, to eligible persons who place in service specified energy property and apply for the payments. The purpose of section 1603 is to reimburse eligible applicants for a portion of the expense of such property. A section 1603 grant recipient is required to reduce the basis of the asset. This change would allow a taxpayer to reduce his or her State taxable income if the taxpayer receives a section 1603 *grant payment* rather than a credit under sections 45 or 48 of the Code. |

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| 1.2 | Deletes the word "adjusted" as used in the definition of North Carolina taxable income for nonresidents and part-year residents.<br><br>In 2011, the General Assembly changed the starting point for calculating NC taxable income from federal taxable income to federal adjusted gross income (Section 31A.1 of S.L. 2011-145). This change simplified the calculation of NC taxable income because taxpayers no longer have to make adjustments to reduce the federal standard deduction and exemption amounts to determine the State deduction and exemption amounts. However, for purposes of prorating NC taxable income for nonresidents and part-year residents, the relevant fraction should only refer to "gross income." By including the word "adjusted" as part of the fraction, a taxpayer could be taxed on more than 100% of their income. |
| 1.3 | Clarifies that the standard deduction amount for individual income tax purposes is the *lesser* of the amount set out in the statute or the amount allowed under the Code. The current law refers only to the "standard deduction amount listed in the table below." However, there are instances where the North Carolina standard deduction is zero[1] or less than is shown in the table. This is another technical change identified by the Department as the result of the passage of Section 31A.1 of S.L. 2011-145. |
| 1.4 | This section makes changes to the sales and use tax exemption statute with regard to motor fuels and installation and delivery charges.<br><br>Motor fuels are subject either to the motor fuels tax or to the sales tax, but not both. Dyed diesel and dyed kerosene are examples of motor fuels that are subject to the sales tax, but are nevertheless defined as motor fuels. This change in the sales tax exemption statute makes it clear that, to the extent a motor fuel is taxed under Article 36C (Gasoline, Diesel, and Blends), it is exempt from sales and use tax.<br><br>This section also amends the sales tax exemptions for delivery and installation charges so that the language is parallel. It adds the phrase "similar billing document," which currently appears in the exemption for delivery charges, to the exemption for installation charges. It adds the phrase "at the time of sale," which currently appears in the exemption for installation charges, to the exemption for delivery charges. |
| 1.5 | This is a technical change because the tax on manufacturing fuel was repealed, effective July 1, 2010. |
| 1.6 | This is a technical change because the existing statutory catchline refers to an Article that does not exist. |

[1] If a taxpayer is (1) married filing a separate return for federal income tax purposes and the taxpayer's spouse itemizes deductions; (2) a nonresident alien; or (3) filing a short-year return because of a change in the taxpayer's accounting period, the taxpayer is not entitled to the standard deduction.

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| 1.7 | This section updates from January 1, 2011, to January 1, 2012 the reference to the Internal Revenue Code. This change keeps the statute up to date, but does not result in any substantive changes because there have not been any federal tax law changes since January 1, 2011 that impact the calculation of North Carolina taxable income. |
| 1.8 | This section adds an additional Code reference to the statute that governs when a return, report, payment, or any other document that is mailed to the Department is timely filed. Code section 7503 addresses when the due date falls on a Saturday, Sunday, or a holiday. |
| 1.9 | This is a technical change to correct a statutory reference. |
| 1.10 | This section conforms the statute on the scope of the local use tax so that it is consistent with the parallel statute for the State use tax, which was amended during the 2011 session. The 2011 change[2] was a clarifying change. |
| 1.11 | S.L. 2011-72 authorized certain cities to establish a municipal service district for the purpose of converting private residential streets to public streets. The act was designed to address 14 residential developments in the Town of Morrisville that were seeking to convert private streets to public streets. After the bill passed, it was discovered that some of the developments were created under the Condominium Act rather than the Planned Development Act, which the bill amended. This section makes the necessary conforming changes. |
| 1.12 | This section corrects several errors in the 2011 special license plate act.[3] It adds the "Mountains-to-Sea Trail" plate to the list of plates that may be on a background other than the First in Flight background, which was the original intent. Under current law, the authorization for the plate states that it "shall bear the phrase 'Mountains-to-Sea Trail' with a background designed by the Friends of the Mountains-to-Sea Trail," suggesting that the organization may design its own background. However, in order for an organization to have a background other than First in Flight, it must be authorized in G.S. 20-63.<br><br>This section also corrects errors with regard to the fees for the Sustainable Fisheries and the Morgan Horse Club plates. |

[2] S.L. 2011-330, s. 25(a).
[3] S.L. 2011-392.

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| 1.13 | This section would allow a taxpayer to claim an Article 3J credit that the taxpayer would have been ineligible for prior to 2010 because it failed to meet the environmental impact standard, which was loosened retroactively that year.<br><br>In 2010, the General Assembly changed the environmental standard for Article 3J retroactively to 2007.[4] By loosening the standard and making the change retroactive to 2007, the General Assembly intended to allow certain taxpayers to file for an Article 3J credit. However, the 2010 change failed to make a corresponding change to the statute of limitations, which requires claims to be filed within six months of the due date of the return. Therefore, a taxpayer who did not claim the credit when the original standard was in effect would be unable to take advantage of the retroactive change which loosened the standard. This change does not have a fiscal impact. |
| **PART II: CLARIFYING AND ADMINISTRATIVE CHANGES** | |
| 2.1 | This change would allow a wholesale or retail dealer of other tobacco products to provide security to the Secretary in the form of an irrevocable letter of credit as an alternative to a bond. An irrevocable letter of credit would typically be used by a foreign company that would be unable to obtain a bond because it does not have assets in this country. This form of security is consistent with what is currently allowed under the motor fuels tax statutes. |
| 2.2 | S.L. 2011-12 added synthetic cannabinoids to the list of controlled substances. No corresponding changes were made to the unauthorized substance tax laws. Therefore, under current law, they would be grouped with "other controlled substances" and subject to tax at a rate of $200 per gram. Marijuana is taxed at |

[4] Sec. 1.3 of S.L. 2010-147 (*Various Economic Incentives)*. Prior to the 2010 change, a taxpayer was eligible for certain economic incentives if the taxpayer had no pending administrative, civil, or criminal enforcement actions based on alleged *significant* violations of any DENR-implemented programs and had no final determination of responsibility for any *significant* administrative, civil, or criminal violation of any DENR-implemented program within the prior five years. Article 3J had a definition of what constituted a "significant violation" but there was some confusion as to whether certain violations met the definition. At the time, the Department made no distinction between civil and criminal violations or on the basis of whether the violation was knowing and willful. The 2010 clarification was designed to ensure that minor violations do not disqualify a taxpayer that would otherwise be eligible for a tax incentive. The current definition of an "environmental disqualifying event," as enacted by S.L. 2010-147, is as follows:

(9a) Environmental disqualifying event. – Any of the following occurrences:

a. During the tax year in which the activity occurred for which a credit is being claimed, a civil penalty was assessed against the taxpayer by the Department of Environment and Natural Resources for failure to comply with an order issued by an agency of the Department to abate or remediate a violation of any program administered by the agency.

b. During the tax year in which the activity occurred for which a credit is being claimed or in the prior two tax years, any of the following:

1. A finding was made by the Department of Environment and Natural Resources that the taxpayer knowingly and willfully, as defined in G.S. 143-215.6B, including all limitations thereto, committed a violation of any program implemented by an agency of the Department.

2. An assessment for damages to fish or wildlife pursuant to G.S. 143-215.3(a)(7) was made against the taxpayer.

3. A judicial order for injunctive relief was issued against the taxpayer in connection with a violation of any program implemented by an agency of the Department of Environment and Natural Resources.

c. During the tax year in which the activity occurred for which the credit is being claimed or in the prior four tax years, a criminal penalty was imposed on the taxpayer in connection with a violation of any program implemented by an agency of the Department of Environment and Natural Resources.

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| | $3.50 per gram. This section would tax synthetic cannabinoids at the same rate as marijuana, effective when the S.L. 2011-12 became law. |
| 2.3 | Holding companies are subject to an annual franchise tax, which is capped at $75,000. A holding company is currently defined as one that receives more than 80% of its gross income from corporations in which it owns, directly or indirectly, more than 50% of the outstanding voting stock or capital interests. However, a corporation whose only asset is an investment in subsidiaries and has no income cannot meet the 80% test because the denominator would be zero. This section expands the definition of a holding company to address this situation.<br><br>The Department has indicated that this is a clarifying change, not a substantive one. A question has arisen about this specific fact pattern where a taxpayer is clearly a holding company in that all of its assets are investments in subsidiaries. For the year in question, the holding company had no income. Therefore, there would be $0 in income from subsidiaries and $0 in total income. Under a strict application of G.S. 105-120.2, $0 divided by $0 would result in an undefined mathematical value. Because it is undefined, it cannot be determined if it exceeds 80%. Alternatively, if one of the subsidiaries of the holding company had issued a dividend of as little as one cent, then 100% of the income would be coming from investments in subsidiaries. The Department believes that this interpretation is not what the General Assembly intended. The Department's interpretation is that it was a holding company and subject to the cap of $75,000 on franchise tax. |
| 2.4 | Makes the definition in Article 3J consistent with the definition of business property in Article 3B[5] and the old provisions for eligible machinery and equipment in Article 3A.[6] |
| 2.5 | Provides that a taxpayer may qualify for innocent spouse relief at the State level if the taxpayer would have qualified for relief at the federal level even if the taxpayer does not have a federal tax liability.<br><br>North Carolina follows federal law with regard to a taxpayer's eligibility for innocent spouse relief. The way the statute currently reads, a taxpayer would have to have had a federal tax liability that he or she was relieved of in order to qualify for relief at the State level. With this change, if the taxpayer would have qualified for innocent spouse relief had the taxpayer had a federal tax liability, then the taxpayer is eligible for relief at the State level. |
| 2.6 | Adds the Education expenses credit to the list of credits that are not allowed to be claimed by an estate or trust. In 2011, the General Assembly enacted the Tax Credit for Children with Disabilities.[7] This is a conforming change that should have been made at the time and is consistent with the other credits that are not eligible to be claimed by an estate. |

[5] G.S. 105-129.15(1).
[6] G.S. 105-129.9(a).
[7] S.L. 2011-395. The credit allows an individual income tax credit for up to $3,000 per semester for tuition and special education and related services expenses for a taxpayer's eligible dependent child with a disability who is enrolled in a nonpublic school or a public school where tuition is charged for the eligible dependent child's enrollment.

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| 2.7 | This section makes two changes to sales tax definitions in order to conform to the Streamlined definitions, and it updates the reference to the most current version of the Streamlined Agreement dated December 19, 2011. |
| 2.8 | This section clarifies the general sourcing provisions to conform to the Streamlined requirements. It was noted during the 2011 Annual Compliance Review that the existing statute was not consistent with the Streamlined requirements. |
| 2.9 | Restores language stating that sales tax must be stated and charged separately that was inadvertently stricken from the statute. |
| 2.10 | This section restores language relating to the application of use tax to items given away by merchants, which was inadvertently deleted in a 2009 budget provision. The language was originally added to the definition of "sale or selling" in 1996 as the result of a court case.[8] The language was intended to restrict the application of that case, a broad application of which could be interpreted in such a way so as to eliminate the use tax. In 1996, the Revenue Laws Study Committee recommended limiting the application of the decision to the facts of that case, which involved food given away by restaurants.<br><br>In 2009, a number of sales tax statutes were amended to address digital property. While amending those statutes, a number of stylistic and technical changes were also made. The language dealing with items given away by merchants was removed with the intent that it be located elsewhere in the sales and use tax statutes as a technical change. However, it was never relocated. This section restores the language by placing it in a new statutory section, effective the date that the 2009 deletion became effective since there was no intent to remove it. |

[8]The use tax, first enacted in 1939, is the complement to the sales tax and applies to the storage, use, or consumption in this State of tangible personal property. Use tax accounts for approximately 5% of total sales and use tax collections. A merchant is liable for use tax on property it ***uses*** in its business, such as furniture, equipment, décor, or promotional giveaways. Items ***sold*** by the merchant, however, are not subject to use tax because sales tax will apply when the items are sold at retail. With regard to items given away free of charge, the general rule in this State, and virtually all states, is that a retailer is liable for sales and use tax on those items. Until 1993, the following items were considered used, not sold, and thus subject to use tax: meals provided free to a merchant's employees, food given away to the merchant's patrons, and matches given away to patrons, other than matches given away along with the sale of cigarettes. A group of restaurants appealed the assessment of the tax, claiming that the items should be considered sold. In *Matter of Rock-Ola Café*, 111 N.C.App. 683 (1993), the North Carolina Court of Appeals agreed with the restaurants that these items should be considered sold along with the food the restaurant sold as part of its business. However, the Revenue Laws Study Committee, in its report to the 1996 Regular Session, concluded that the Court's opinion was overly broad in its rationale. The rationale, that the cost of these items is recovered by the sales of other items, taken literally and if applied broadly, could be interpreted to eliminate the use tax altogether in that the cost of all of a merchant's purchases are ultimately covered by the price of sold items. The Committee recommended, and the General Assembly enacted, the language in this section to limit the application of the court's opinion to the facts of that case, which dealt specifically with restaurants. Under this language, property given away by a merchant is exempt from use tax only in the case of restaurants that provide free meals to employees or free bar food to patrons. The bill that was ultimately enacted added language to exempt items of inventory given away to a customer free of charge on the condition that the customer buy similar property ("buy one, get one free").

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| 2.11 | This section makes two changes related to sales tax refunds for interstate carriers. First, it modifies the reference to "them" to make it clear that, for purposes of calculating a refund on certain cars, parts, fuel, and repair parts, an interstate carrier must include all motor vehicles, railroad cars, locomotives, and airplanes that the applicant owns or leases and that are operated both inside and outside the State in the denominator. Second, it clarifies that airplane miles are not in this State if the airplane only flies over North Carolina but does not take off or land in the State. |
| 2.12 | A direct pay permit authorizes the holder to purchase property that is subject to sales and use tax without paying the tax to the seller. A person who purchases an item under a direct pay permit is liable for use tax, which is payable when the property is placed in use or the service is received. A person can apply for a direct pay permit if the person purchases an item whose tax status cannot be determined at the time of purchase, and either:<br>• The place of business where the item will be used is not known at the time of purchase and a different tax consequence applies depending on where the item is used, or<br>• The manner in which the item will be used is not known at the time of purchase and one or more of the potential uses is taxable but others are not taxable.<br>Generally speaking, a direct pay permit is not intended to allow purchasers to "shop" for a lower tax rate. It was originally designed to address situations where a purchaser of machinery, for example, did not know at the time of purchase how the machinery was going to be used and, therefore, whether it would be subject to sales tax at the general rate, exempt from tax, or subject to the 1%/$80 rate. In those cases, however, the property was always going to be used in North Carolina. The Department is aware of a situation where a retailer that has purchased items from NC vendors and has taken delivery of those items in NC wants to use a direct pay permit arguing that the items may be shipped out of state at some later date for use in another state. This section adds the words "for storage, use, or consumption in this State" to make it clear that a direct pay permit may not be used to avoid paying NC sales tax in this way.<br>A person who purchases telecommunications service under a direct pay permit must file a return and pay the tax due monthly to the Secretary. This section adds the word "quarterly" so that the filing frequency is consistent with the filing frequency for general State and local sales tax remitters.[9] By providing for quarterly filing, this change would conform the statute to current practice at the Department. |

[9]A taxpayer who is consistently liable for less than $100 a month in State and local sales and use taxes must file a return and pay the taxes due on a quarterly basis. A taxpayer who is consistently liable for at least $100 a month but less than $20,000 a month in State and local sales and use taxes must file a return and pay the taxes due on a monthly basis. (G.S. 105-164.16.)

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| 2.13 | There is an excise tax imposed on piped natural gas received for consumption in this State, which is in lieu of the sales and use tax. The tax is payable on a monthly basis. Under current law, a taxpayer who is consistently liable for at least $10,000 of tax a month must make a monthly prepayment of the next month's liability.<br><br>This section would change from $10,000 to $20,000 the prepayment threshold for the tax on piped natural gas, the purpose of which is to be consistent with the prepayment threshold for retailers required to remit sales and use tax.[10] This change does not change the amount of excise tax revenue remitted to the General Fund, but it does change by one month the timing of the payment for the year of the transition to the higher threshold. The Department indicates that it knows of only one company that would be affected by increasing the threshold to $20,000. |
| 2.14 | Generally speaking, the State may not contract with foreign vendors that refuse to collect use tax, where applicable, on sales delivered to North Carolina. G.S. 143-59.1 requires the Department to periodically provide to the Secretary of Administration a list of ineligible vendors based on this requirement. This section provides that the Department of Administration may not enter into a contract with a vendor if the Department of Revenue has determined that the vendor or an affiliate of the vendor refuses to collect use tax. This language has been agreed to by both the Department of Revenue and the Department of Administration. |
| 2.15 | This section conforms the statute to current practice at the Department. If a taxpayer files a return electronically, then the taxpayer must pay the tax due before the taxpayer may submit the return. |
| 2.16 | This section removes the confusion caused by the new fee applicable to the recording of subsequent instruments by eliminating the fee and imposing a $10 fee for an instrument that assigns more than one security instrument by reference to a previously recorded instrument. S.L. 2011-296 changed the fees collected by register of deeds for the purpose of simplifying their collection and remittance. As part of the legislation, a new fee became applicable to the indexing and filing of "subsequent instruments." Several registers of deeds have questioned how to apply the new fee applicable to subsequent instruments that contain references to multiple recorded documents, such as cancellations of multiple deeds of trust or substitution of trustee in multiple documents. |

[10]For sales and use tax, the threshold limit of $10,000 was enacted in 2001 as a means to accelerate the payment of sales and use tax dollars into the General Fund for fiscal year 2001-02. Prior to this change, the threshold amount for making bimonthly payments was $20,000. In the years following 2001, the sales and use tax rate, at its highest, reached 7.75%. The lowering of the threshold amount along with the increase in the tax rate subjected more retailers to the most extensive sales tax remittance requirements. Consequently, many small retailers expressed a cash flow hardship with the pre-payment requirement. In 2010, the General Assembly phased in a restoration of the $20,000 prepayment threshold. The change decreased the number of retailers required to submit a prepayment of 65% of the amount of sales tax revenue to be remitted for the following month.

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| 2.17 | This section makes conforming changes to the statutes dealing with the State Home Foreclosure Prevention Project (SHFPP). The SHFPP was created by the General Assembly in 2008[11] as an emergency program and was expanded and extended in 2010[12] to cover all homeowners. The program is an effort to reduce unnecessary foreclosures providing homeowners with free resources, such as counseling, as they work with servicers to create alternatives to foreclosure.<br><br>In 2011, the administration and staffing of SHFPP homeowner and counseling activities was transferred to the NC Housing Finance Agency, effective July 1, 2011.[13] Under that legislation, the Office of the Commissioner of Banks retained administration of the pre-foreclosure filings database, servicing invoicing, and the granting of 30-day extensions.<br><br>This section would complete the transfer of all program activities to the NC Housing Finance Agency and would remove the program sunset. |
| **PART III: COMBINED MOTOR VEHICLE REGISTRATION/PROPERTY TAX CHANGES** | |
| In 2005, the General Assembly created a framework establishing a combined system for motor vehicle registration renewal and property tax collection. Originally, the act was to become effective the earlier of January 1, 2009, or the date that the Department of Revenue and the Division of Motor Vehicles certified that an integrated computer system is in operation. The effective date has since been extended and is currently set to go into effect July 1, 2013. Under the new system, the taxpayer/motor vehicle owner will receive one bill for property taxes and the DMV license renewal, and DMV will be the collecting authority. Counties will still determine the value and the taxability situs of motor vehicles. A number of conforming changes are needed to fully implement the combined system, which goes into effect July 1, 2013. Part III of this bill consists of those changes. | |
| 3.1 | Current law permits the governing body of a taxing unit to pass a resolution directing its tax collector not to collect minimal taxes, defined as up to $5.00, charged on tax records and receipts. This section would exempt taxes on registered motor vehicles for two reasons: (1) a minimum of $28 is collected for motor vehicle registration; and (2) DMV, not the counties, will be the collecting authority. Therefore, the minimal tax provision is not applicable with regard to combined motor vehicle and property tax collection. |

[11] S.L. 2008-226.
[12] S.L. 2010-168.
[13] S.L. 2011-288.

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| 3.2 | A taxpayer may appeal motor vehicle taxes on a number of grounds: the valuation by the county, the denial of an application for exemption or exclusion, and on the grounds that the county does not have authority to tax the vehicle because the situs of the vehicle is in another taxing district. The term "taxability" in the appeal statutes has been used to refer to both exemption status and situs, but because there are different time periods that apply depending on the basis of a taxpayer's appeal, the Department recommends separating the statutory provisions.[14]<br><br>Therefore, this section strikes the term "taxability" from G.S. 105-330.2(b1) so that, as amended, this subsection would apply only to appeals based on valuation. It also creates a new subsection (b2) to address appeals based on an application for exemption or exclusion. Appeals based on a county's authority to tax are covered under current law in G.S. 105-381. |
| 3.3 | This section establishes a process for the collection of property tax on an unregistered vehicle. The objective of the process is to ensure that the taxpayer is not double-taxed and that property taxes are paid on motor vehicles that a person owns even if it is not registered. If a person does not register or renew registration, then the person would be required to list the vehicle with the county assessor. The listing will generate a tax bill. However, if the person subsequently registers or renews the tag for the vehicle, then DMV will charge the person for the registration plus the property tax. This provision allows a county to ignore the listing to the extent the person registered or renewed within the same year. |
| 3.4 | This section clarifies that counties would have authority to use collection remedies for unpaid motor vehicle taxes that were billed prior to the effective date of the combined motor vehicle/property tax system. The August 1 date is used because the tax year for July renewals begins August 1.<br><br>This section also changes the term "tax collector" to "collecting authority" because under the new system, DMV and not the county tax assessor or tax collector will be the collecting authority. |
| 3.5 | This section repeals an unnecessary statute that relates to small underpayments and overpayments of motor vehicle taxes. Specifically, if a taxpayer fails to remit the additional $1.00 charged for payments that are mailed rather than paid in-person, the collecting authority is not permitted to bill or attempt to collect the additional $1.00. However, there is no longer a $1.00 charge for mailed in payments so the provision is unnecessary. |
| 3.6 | This section is a conforming change to the effective date. When the effective date for the implementation of the combined system was changed, this particular session law was missed. |



[14] A taxpayer has 30 days to appeal a determination of value or eligibility for an exemption or exclusion. However, there is a five-year period to appeal an "illegal" tax under G.S. 105-381.